

STAFF REQUEST FOR PERMISSION TO PROCEED WITH A PUBLIC
MEETING TO DISCUSS A POSSIBLE ADDITION TO REGULATION 25137,
SUBS. (c), TO INCLUDE ONLY THE NET GAINS FROM THE SALE OF
CERTAIN INTANGIBLES IN THE SALES FACTOR

Staff requests Board approval to schedule a public meeting to discuss a possible addition to Regulation 25137, subsection (c), to include only the net gains from the sale of short-term financial instruments in conjunction with a business' treasury function.

A number of corporations make investments in short-term financial instruments with their idle cash. Because the cash needs of a business may vary substantially from day to day, these investments necessarily must be in highly liquid assets and frequently for periods of no more than several days. The income arising from each transaction is frequently relatively small, and there are frequently a large number of transactions. If such transactions are included in the sales factor, they can represent a preponderance of the total sales of the business.

This issue was addressed by the State Board of Equalization in the *Appeal of Pacific Telephone and Telegraph*, decided May 4, 1978. In that decision the board ruled, under the facts of that case, that only the net gains from such transactions should be included in the sales factor because such activity was ancillary to the business of the taxpayer and that to include all of the receipts would not fairly reflect the activities of the taxpayer in this state. In a subsequent case, *Appeal of Merrill, Lynch, Pierce, Fenner & Smith*, decided June 2, 1989, the State Board of Equalization ruled that a securities dealer could include in its sales factor all of the receipts from such activity because it was in the business of trading securities. The board distinguished the facts in that case from those in *Pacific Telephone*.

A number of taxpayers have raised this issue in claims for refund filed with the department, in appeals to the State Board of Equalization, and in suits for refund. Except in the case of securities dealers, the taxpayers have been unsuccessful in having the receipts from these activities included in the sales factor. Two of the six litigation cases where this issue is present have been decided by the trial court in favor of the Franchise Tax Board on motions for summary judgment on a different but related theory involving whether the transactions gave rise to gross receipts. In one of the cases, the trial judge, in *dicta*, indicated he would have ruled in favor of the FTB's motion for summary judgment if he had been required to reach this issue.

The Multistate Tax Commission (MTC) has adopted Model Regulation IV.18.(c).4 that would include only the net gain on such transactions in the sales factor. This model regulation may serve as one potential approach to the problem. Staff believes that the adoption of a regulation in this area would provide needed

guidance to taxpayers and to FTB staff as to how to deal with these situations and to what extent such activity should be reflected in the sales factor.

A proposal to amend Regulation 25137, subsection (c), based upon the MTC proposal, was the subject of a public symposium in June of 1998. At the August 6, 1998, meeting of the Franchise Tax Board, members Connell and Andal directed staff to abandon this proposed regulation project. Staff's proposed rule-making calendar for the year 2003 included this matter. At the Board meeting of November 26, 2002, the Board unanimously approved the rule-making calendar as proposed by staff for 2003 "with the exception of items previously rejected by the Board." The language of that Board action would appear to apply to a possible amendment to Regulation 25137, subsection (c).